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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 288

JOHN P. DALEY, MINERVA B. DALEY, MORRIS DALEY, ZELMA B. DALEY, WILLIAM RADTKE, CLARA RADTKE and HOMER BOSSE, Trustee of the Estates of Morris K. Daley, Alice M. Daley, Susan R. Daley, James D. Daley, Kathryn F. Daley and Peter D. Daley, *Petitioners*,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

To the Honorable, Chief Justice, and the Associate Justices of the Supreme Court of the United States.

The Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above cause on April 18, 1957.

OPINION BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit, reported at 243 F. 2d 466, is set forth in the Appendix, p. 1a. The opinion of the United States District Court for the Northern District (Southern Division) of California is set forth in the printed record below at page 102.

JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on the 18th day of April, 1957. The jurisdiction of this Court is invoked under Section 1254(1), 28 U.S.C. of the Judicial Code.

QUESTIONS PRESENTED

1. Whether the courts below erred in finding that the Delta Venture return was filed under the accrual basis of accounting and did not use the completed contract method of reporting income.

2. Whether the courts below erred in holding petitioners' refund claims insufficient to support a refund based upon the trial court's finding of the improper accrual of income in 1942 reportable in 1943.

3. Whether, if the claims for refund were considered defective,

   (a) were such defects waived by the Respondent's conduct and knowledge of the basis for the claims, and if not, should the petitioners be permitted to offer evidence to show such waiver, and

   (b) were such defects cured or waived by the pleadings and/or a supplemental stipulation for refund based upon the court's findings. [R. 101]

STATUTES INVOLVED

The pertinent portions of Sections 41, 42 and 43, and Section 3772, of the Internal Revenue Code of 1939 are set forth in the Appendix, p. 18a.

STATEMENT OF THE CASE

Petitioners were members of a joint venture known as Daley Brothers Delta War Venture which undertook a single contract for construction. The Venture commenced the performance of the contract with the United States on July 8, 1942, and completed it on February 16, 1943. On March 15, 1943, the Venture filed a partnership information income tax return for the calendar year 1942. The individual petitioners filed individual income tax returns for 1942 based on the 1942 Venture return.

The books of the Venture were kept by Daley Brothers, Ltd., one of the members of the Venture. Daley Brothers, Ltd. since 1935 had filed tax returns using the completed contract method, the books employing the accrual basis of accounting. The 1942 information return filed by the Venture reported all receipts and all disbursements, actual and anticipated, under the contract as though all such receipts and disbursements had been properly paid or accrued in 1942 and as if the contract had been wholly completed by December 31, 1942. The return was erroneous, whether upon the completed contract method or upon a strict accrual basis of reporting income.

In 1947 the Venture filed amended information income tax returns for 1942 and 1943, accompanied by refund claims by the distributees of the Venture's net income, petitioners herein (R. 86-95). The original

and the amended returns indicated the "accrual" basis. The refund claims did not refer to either the completed contract method or the accrual basis. The purpose was to correct the 1942 return by showing the contract receipts in 1942 as "advances" and correctly to accrue receipts and disbursements and gross profit in the year 1943, the year of completion of the contract. The intent was to file a proper return, to correctly report income in the year earned, as required by law. The effect of this change would result in tax refunds upon the returns of the petitioners for 1943. The claims for refund were denied by the Commissioner. Under the provisions of Title 28 U.S.C. 1346(a)(1)(ii), suit was brought in the United States District Court for the Northern District of California, Southern Division, which Court on February 29, 1956, decided against the petitioners (R. 102). Findings of Fact, Conclusions of Law, and Judgment were entered on March 23, 1956 (R. 107-113). Plaintiffs appealed to the United States Court of Appeals for the Ninth Circuit, which, by Opinion filed April 18, 1957, affirmed the District Court.

The District Court held that

> "* * * all of the income from the contract was intentionally reported as accruing during the year 1942, although a portion of the income from that contract did, in fact, accrue in 1943 * * *" (R. 110)

The District Court further found, as a conclusion of law, that the Venture

> "* * * elected to report the income from the War Department contract for the year 1942 on the accrual basis of accounting. That portion of the income from the contract that *actually accrued in 1943 cannot be refunded in this action* because

the grounds stated in the refund claims, and the basis asserted in the complaint for refund, were solely that *all* of the receipts from the contract had been erroneously reported as income in 1942 * * *" (R. 111). (Italics supplied)

The District Court found that *some* of the contract income did not in fact accrue until 1943, and therefore was improperly reported as 1942 income, but denied recovery of the overpayment on grounds of insufficiency of the claims for refund. The amount of such income improperly reported in 1942 was $472,722.15. The Court of Appeals refused to remand the case for computations on the basis of the accrual method, and to afford petitioners opportunity to submit evidence that respondent was at all times, through conferences and documentary material, fully apprised of the improper accruals and the claims for refunds based thereon. Respondent had notice that the original and amended returns of the Venture were filed on the accrual basis. The returns so indicated (R. 86-90). Respondent's counsel in the trial court so contended (R. 127, 136). Respondent contended that the accrual method of accounting was properly applied and that the returns were substantially correct on the accrual theory; that substantially, if not all, of the contract income was earned in 1942.

REASONS FOR GRANTING THE WRIT

Petitioners assert that certiorari should be granted in this case for the reasons:

(a) The decisions of the District Court and the Court of Appeals in this case are in conflict with applicable decisions in this court. *Helvering* v. *Enright*, 312 U.S. 636; *Spring City Foundry Co.* v. *Commis-*

sioner, 292 U.S. 182; *Aluminum Castings Co.* v. *Routzahn*, 282 U.S. 92; *Weiss* v. *Weiner*, 279 U.S. 333; *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552; as to sufficiency of claim or waiver of defects, see *Tucker* v. *Alexander*, 275 U.S. 228; *U.S.* v. *Garbutt Oil Co.*, 302 U.S. 528.

(b) If previous decisions are not directly applicable to this case, then the courts below have decided an important question of Federal law which has not been, but should be, fully settled by this court.

The courts below became confused with the technical details and distinctions of the accrual method of accounting and the completed contract basis of reporting taxable income.

Athough the District Court found that the Venture "elected" to file a 1942 return on the accrual basis, and found that all of the contract income had been included in the 1942 return, it still concluded that this did not represent the completed contract method of reporting income. The District Court explains away this error by finding that the Venture's 1942 return erroneously reported $472,722.15 of income which should have been accrued and reported in 1943. And although the courts below experienced no difficulty in discovering the erroneous reporting of such income, on the basis of a comparison of the original and the amended returns and the Exhibits and stipulations, both courts found that the Commissioner of Internal Revenue was not sufficiently apprised of the grounds for the refund claims. The petitioners find themselves in the dilemma of being required by the Court to state as a ground for refund a specific reason or theory which did not exist until the District Court entered

its findings, conclusions and opinion. The opinions below seem to imply that the petitioners made a mistake in the 1942 return and should be denied the right to correct the mistake because the correction would result in a tax refund. The returns were prepared by an accountant who testified he thought they were correct (R. 218-219). The Internal Revenue Service would not accept such a theory if the situation were reversed, but would insist upon a true and clear reflection of income where the result would be additional taxes.

The original return for 1942 was filed upon the accrual basis of accounting and was intended to follow the completed contract method of reporting income. It was incorrect in that it improperly accrued income reportable in 1943 and in that it employed the completed contract method to report income upon a contract not actually completed until February 16, 1943 at the earliest. The amended returns for 1942 and 1943 were filed to correct both errors. Clearly on the face of the amended returns $472,722.15 of income had been erroneously included in the 1942 return on the accrual basis and correctly included in the 1943 amended return. The claims for refund (R. 86-90) when considered in conjunction with the accompanying amended returns, set forth sufficient explanation and reasons for the refunds resulting from a correction of the erroneous reporting of income from the Delta contract. In any event the Commissioner's representatives had actual knowledge that petitioners, as an alternative to the completed contract method of accounting as a basis for recovery, contended that even under the accrual method of accounting petitioners were entitled to the refunds, inasmuch as $472,722.15 did not accrue in fact or in law until 1943.

The reasoning of the District Court, concurred in by the Court of Appeals is that petitioners should have alleged that only *part* of the income, $472,722.15, rather than *all* of the income from the Delta contract, was erroneously included in 1942. The courts have never required such refinement and precision in a claim for refund. The Respondent had ample opportunity to make administrative review and decisions between the filing of claims in 1947 and the filing of suit in 1952. Respondent consistently took the position that the books and returns were on the accrual basis and the returns were correct. In the Court of Appeals Respondent contended that even if the accrual reporting was in error the taxpayers were estopped by a so-called "election" and could not obtain a refund as the result of attempting to correct the error. Petitioners contend they themselves were the ones misled and taken by surprise by the Respondent's conduct in raising for the first time in the trial court highly technical objections to the form of the claim.

As to the sufficiency of the claims for refund, petitioners cite the following cases: *Tucker* v. *Alexander*, 275 U.S. 228; *U. S.* v. *Garbutt Oil Co.*, 302 U.S. 528; *U. S.* v. *Andrews*, 302 U.S. 517; *U. S.* v. *Memphis Cotton Oil Co.*, 288 U.S. 62; *Hrcka* v. *Crenshaw*, 237 F. 2d 372; *Howbert* v. *Penrose*, 38 F. 2d 577, at 581; *Underwood* v. *Commissioner*, 56 F. 2d 67; *Commissioner* v. *Wells*, 132 F. 2d 405; *Lehigh & Wilkes-Barre Coal Co.* v. *U. S.*, 38 F. 2d 637; *Reynolds* v. *McMurray*, 77 F. 2d 740; *U. S.* v. *Elgin National Watch Co.*, 66 F. 2d 344; *U. S.* v. *Humble Oil & Refining Co.*, 69 F. 2d 214; *Foster Box Board Co.* v. *Clarke*, 7 F. Supp. 682; affirmed 90 F. 2d 1008; *Smale & Robinson, Inc.*

v. *U. S.*, 123 F. Supp. 457; *Clark* v. *U. S.*, 143 F. Supp. 165; *C. W. and Mattie Stillwell* v. *U. S.*, U.S.D.C., Western District of Virginia, Docket 546, decided May 23, 1957, appeal pending.

CONCLUSION

Regardless of the terminology used or the precision of language in the claims or returns, the simple situation is that petitioners (a) filed incorrect returns for 1942, reporting *all* Delta income; (b) filed timely amended returns and claims for refund to correct the error; and (c) proved that *at least* $472,722.15 had been incorrectly reported in 1942 instead of 1943. Therefore this court should grant certiorari to review the errors committed below in denying any relief to petitioners under all the circumstances.

Wherefore petitioners pray that a writ of certiorari may issue directed to the United States Court of Appeals for the Ninth Circuit and upon review, that the judgment of said Court of Appeals be vacated, reversed and set aside and that this case be remanded to said court with instructions to proceed further in accordance with the opinion of this court.

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sufficient to apprise the Commissioner of the exact basis thereof." *Rogan* v. *Ferry*, 9 Cir., 1946, 154 F. 2d 974, 976.

See U.S. Treas. Regs. 111, § 29.322-3 (1943): *French* v. *Smyth* (N.D. Cal., 1952), 110 F. Supp. 795, and cases therein collected, *aff'd sub nom. French* v. *Berliner*, 9 Cir., 1955, 218 F. 2d 351.

It is urged that an examination of the refund claims, together with the accompanying amended returns, demonstrate that the improper accrual of receipts was set forth as a ground for refund.

The identical refund claims read in part:

> "... The amended returns are to correct the Delta, Utah, contract, which was completed in the year 1943 and erroneously included in income for the year 1942. ..."

No mention is made of the improper accruals alleged to be in issue, but reference is made to accompanying amended returns. Appellants compare the original 1942 return showing gross receipts of $3,655,672.28 with the amended return for 1942 showing "advances" of $3,180,536.97. The item in question, $472,722.15, if added to the "advances" figure on the amended 1942 return, would total $3,653,259.15, the total contract price. Thus, it is said that a comparison of the two returns discloses that the final progress payments and "holdbacks" from 1942 progress payments were improperly accrued as 1942 income.

This discrepancy is not sufficient to apprise the Commissioner of the improper accruals, because the amended return is consistent with, and solely indicative of, a proper application of the completed contract method. The foregoing, taken together with the statement in the refund claim, fortifies the conclusion that the only stated basis for refund was upon the theory of an application of the completed contract method.

Appellants also contend that the allegations of the complaint sufficiently set forth the improper accruals, which in the face of a failure of the Commissioner to raise the inadequacy of the refund claims in his answer, require a recovery. Paragraph IX of the complaint is pointed to as being sufficient; it reads:

> "That at the end of the calendar year of 1942, an income tax return was made for the special partnership, notwithstanding the fact that the contract was not completed and accepted before December 31, 1942, and said income tax return was erroneously made and reported under the mistaken theory that the income was earned in the calendar year 1942. This income was then inadvertently reported by the plaintiffs as income as to their respective shares by the plaintiffs herein on their individual returns for said year."

The statement is no more than an allegation of appellants' reliance on the completed contract method, and does not ask a refund on the theory of an improper accrual of two particular items. In a word, appellants advised the Commissioner in their claims for refunds that all of the income from the contract should have been reported in 1943, on a completed contract basis. They did not advise the Commissioner that *certain items of 1943 income* were improperly included in the 1942 return.

Appellants further contend that Rule 54(c) of the Federal Rules of Civil Procedure would allow recovery irrespective of the defective refund claims. As we read the rule,[9] it cannot remedy an existing defect in a refund claim,

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[9] Fed. R. Civ. P. 54(c) provides:

> "(c) Demand for Judgment. A judgment by default shall not be different in kind from or exceed in amount that prayed for in the demand for judgment. Except as to a party against whom a judgment is entered by default, every final judgment shall grant the relief to which the party in whose favor it is rendered is entitled, even if the party has not demanded such relief in his pleadings."

and cannot provide a recovery where the grounds are not stated in the refund claim.

Appellants urged for the first time upon appeal that the Commissioner has by his conduct waived any defect in the refund claims. We cannot remand this cause to the trial court when the issue could have been litigated during the trial.

Even though, as we have heretofore pointed out, the appellants did elect to use the accrual accounting method, that method is not binding upon them, if it fails clearly to reflect income from the Delta contract. Appellants contend that it does not, and that they may therefore employ the completed contract method of accounting in reporting income from the Delta contract. In the event a taxpayer elects a method of reporting income which does not clearly reflect income, the Commissioner is free to recompute the income in accordance with a method which does so;[10] likewise, it is argued that the taxpayer is not bound by an election to report income upon a method of accounting which does not clearly reflect income.[11]

That proposition cannot afford appellants any comfort in the instant case. The accrual method clearly reflects income from the Delta contract.

Appellants' first contention on this phase of the case is bottomed upon the assumption that the two items improperly accrued as 1942 income, viz.: the 1942 "holdbacks" and the 1943 progress payments, a total of $472,722.15, distort the true income picture. The fact that appellants erroneously included said amounts in the 1942 income return, rather than as 1943 income, is not sufficient to demonstrate that the accrual method does not truly reflect income. The

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[10] Int. Rev. Code of 1939, §41, 53 Stat. 24.

[11] Lebolt & Co. v. United States, 1929, 67 Ct. Cl. 422; accord, Ross v. Commissioner of Internal Revenue, 1 Cir., 1948, 169 F.2d 483.

erroneous application of an accounting method by a taxpayer cannot be said to transform that method from one which clearly reflects income into one that does not.

Appellants then argue that the accrual method, *properly applied,* would not clearly reflect income from the Delta contract.

It must be realized that the completed contract accounting procedure is not operative until the net income or loss is determined; and its use is not characterized by the entries in the primary accounts. Either the cash receipts and disbursements method or an accrual method can be employed in the primary accounts of a concern electing to report taxable income upon the completed contract basis.

Many accounting procedures can be grouped under the definition of accrual accounting. See, *e.g., Maloney* v. *Hammond,* 9 Cir., 1949, 176 F. 2d 780. Essentially, an accrual method recognizes income when the taxpayer has an unrestricted right to the money,[12] and deductions are taken when "'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."[13] Taxable income is reported upon an annual accounting concept.[14]

With respect to the Delta contract, the items of income consisted of the partial progress payments paid at the end of each calendar month upon approved estimates and ten per cent "holdbacks" from those progress payments, paid upon completion and acceptance of all the work done under

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[12] Spring City Foundry Co. v. Commissioner, 292 U.S. 182; Estate of Putnam v. Commissioner, 324 U.S. 393; Dixie Pine Products Co. v. Commissioner, 320 U.S. 516; U.S. v. Anderson, 269 U.S. 422; Continental Tie & L. Co. v. U.S., 286 U.S. 290.

[13] Int. Rev. Code of 1939, § 43, 53 Stat. 24; see U.S. Treas. Regs. 111, § 29.43-1 (1943).

[14] Burnet v. Sanford & Brooks Co., 282 U.S. 359.

the contract.[15] Under an accrual accounting method, the partial progress payments would accrue in the year when the right to receive the payments ripened with certainty.[16] The remainder of the contract price would not accrue until the completion and acceptance of the contract.[17] Costs would be apportioned over the contract price, and the costs applicable to the income accrued at the end of 1942 would be deducted in that year. *Accord, U.S.* v. *Anderson*, 269 U.S. 422; see Wagman, *Tax Accounting for Long-Term Contracts*, 33 Taxes 277.

As a matter of practice, either the completed contract or the percentage of completion method might be preferable to a more traditional accrual accounting system and might reflect income more accurately. But we cannot agree that an accrual method, reporting upon a fiscal year and accruing income and spreading deductions as hereinbefore stated, would not clearly reflect income from the Delta contract. The Venture elected to report taxable income upon an annual accrual basis, and is bound by its election.

Affirmed.

(Endorsed:) Opinion. Filed Apr. 18, 1957.

PAUL P. O'BRIEN, *Clerk*.

Sec. 41 [Internal Revenue Code]. The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such

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[15] See note 1, supra.

[16] Clark v. Woodward Const. Co., 10 Cir., 1950, 179 F.2d 176.

[17] Daily v. Commissioner, 9 Cir., 1955, 227 F.2d 724.

method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

Sec. 42 [Internal Revenue Code]. (a) GENERAL RULE.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.

Sec. 43 [Internal Revenue Code]. The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death.

SUITS FOR REFUND

Sec. 3772 [Internal Revenue Code]. (a) LIMITATIONS.—

(1) CLAIM.—No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected until a claim for refund or credit has been duly filed with the Commissioner, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.